RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 • REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION
POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

August 7, 1985 LETTER 919

July 26 DJIA 1357.08; PTI 1902; A-D Ratio -13.21
Aug. 2 DJIA 1353.05; PTI 1906; A-D Ratio -13.44

THE PICTURE: Question: Russell, what do you think is happening in the market and the economy at this time?

Answer: First, let's turn to the market: The D-J Utility Average hit its record high of 168.91 on July 12. From there the Utility Average (which is often a market bellwether) fell rapidly. On July 17 the D-J Transportation Average struck a record high of 702.60. Two days later (July 19) the D-J Industrial Average recorded an all-time high of 1359.54. From the July 19 peak, all three Averages sank rapidly. So much for the actual price structure.

My gut feeling is that at the July highs the stock market was over-extended (see Late Notes on page 6 of the last Letter) and that a correction was way overdue. But my guess is that what we've been seeing is only a correction -- not the beginning of a primary bear market.

I base this on my estimation that the "normal" signs of a major bull market top were lacking at the July highs. The major Averages all recorded historic highs in July (with no divergences). Volume was high in July, debit loans at the brokerage houses were at record highs as were credit balances (all these are positive for the trend). And most important, the economic news has been worrisome, if not downright bearish. All of which hardly constitutes the sort of background one would expect at a major bull market top. For those of you who don't remember, major bull market tops are usually accompanied by blue skies, boundless optimism and a feeling that "the market is going up forever".

Question: Russell, what about your Primary Trend Index?

Answer: My PTI measures the market's technical balance on a daily basis. This balance is comprised of eight critical market indicators, each having to do with actual market ACTION. The PTI has served over and over again to keep me and my subscribers on the right side of the market. The PTI often leads the market, it is sometimes coincident and very occasionally it lags. But a persistent rise in the PTI ALWAYS takes the market with it on the upside, just as a persistent decline ALWAYS drags the market to lower levels.

Note that the PTI turned up decisively in early January 1985, and it has been in a relentless rising trend ever since. On August 1, the PTI recorded a new bull market (and all-time) high of 1910, and it is well to note that the new PTI high occurred even while the A-D ratio was well below its July high.

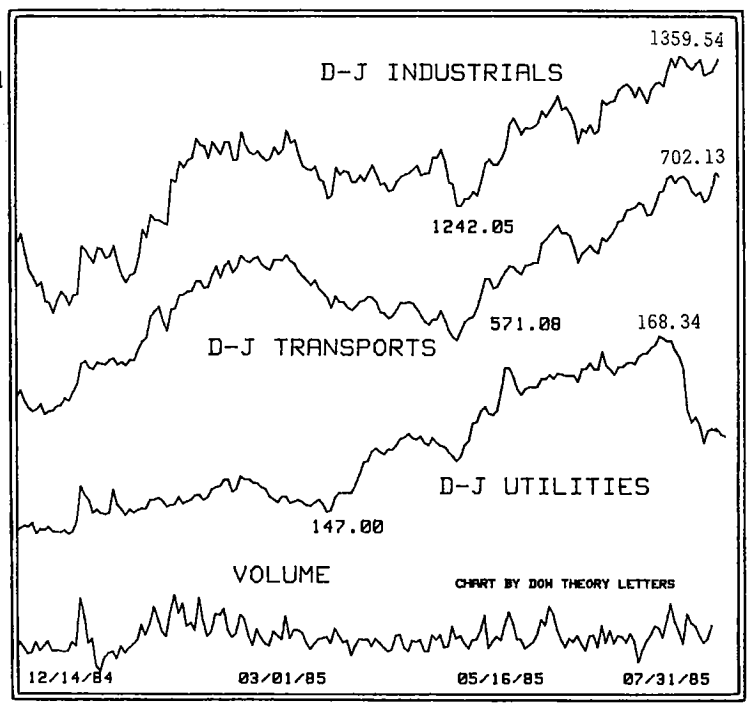
Question: What do you think the PTI is telling us?
Answer: It's telling us that the market's technical structure is still strong.

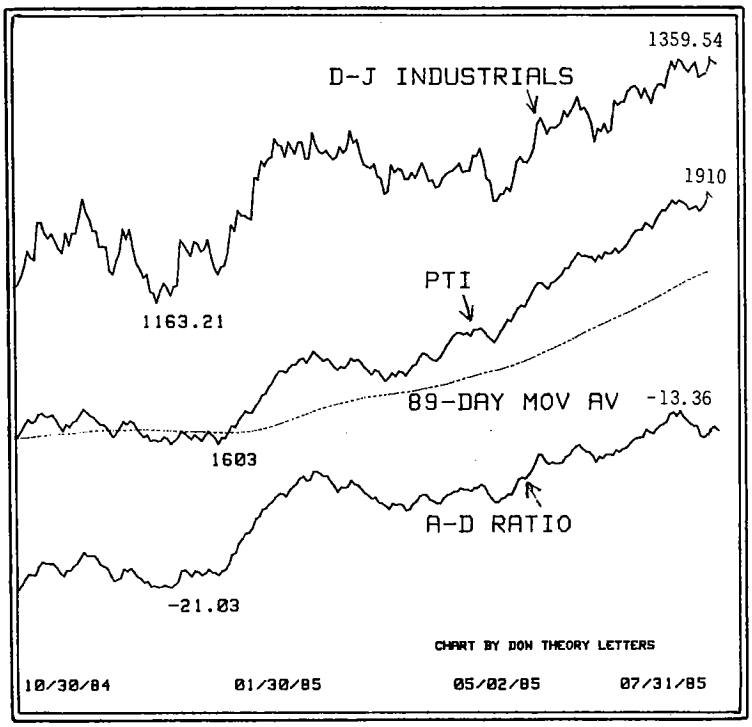
Question: Why do you keep the construction of your PTI a secret?
Answer: This is the sole secret that I have in the market. I spent five years (1966-71) experimenting with the construction of the PTI, and I began publishing the PTI chart in these Letters in 1971. Most of the mistakes I have made since 1971, I made by not believing my own indicator. So over the years, I have learned never to go against the established trend of the PTI, and I think those subscribers who have followed the PTI have found it a valuable guide to the major market trend.

The reason I have never divulged the secret of the PTI is that I feel if its construction were made public, everyone and anyone could follow it, and in a matter of time its usefulness would be greatly reduced. I have never, in 40 years of watching markets, seen a widely-followed indicator that did not malfunction or lapse into uselessness. This is the reason I keep the PTI a secret.

Question: OK, Russell, so you're bullish on the market. But suppose you're wrong? Or let me put it another way, how will you know if you're wrong?

Answer: When the Averages climb to historic peaks and turn down, there is no one alive who can guarantee that a bear market has not started. All you can go by is opinions and gut feelings. Turning to the price structure again, the last secondary lows were 1242.05 for the D-J Industrials and 571.08 for the





Transports. If the two Averages were to go down and down and ultimately (without an upward correction) break those lows (see page 1 chart) then I would consider the primary trend to have turned bearish.

But a more usual bear signal would be given if the two Averages decline for a period of a few weeks to a few months, then turn up but one Average or both fail to better their July highs. If, on the next drop, the preceding lows are broken, a bear market will have been signaled.

Question: What about the swooning action of the Utilities?

Answer: Although the Utilities tend to be a bellwether Average and although they were the first of the three Averages to turn down, the Utilities play no part in Dow Theory. The Utilities, however, are very sensitive to interest rates, industrial capacity and government rate policies. Therefore, I never write off a big break in the Utility Average (such as the one we have just seen). But the true meaning of the Utility break will only be understood weeks or even months from now.

Question: How does all this fit in with the current economic picture?
Answer: The economists, the businessmen, the bankers and the politicians have, in my opinion, been living in a never-never dream world! Congress has not taken any real steps to cut the deficit, the trade deficit has been of almost disastrous proportions, and the banking system, the thrift system and the whole farm system are literally in tatters.

It's been my opinion that this nation has been (financially speaking) out of control for many years. Productivity has been low, the US savings rate has been absurdly low, debt is absurdly high and the nation's lawmakers appear to be oblivious to what's going on -- or to what the American people want. In fact, I have felt that the politicians were (and still are) far BEHIND the people in addressing themselves to what needs to be done. I believe that Reagan's sweeping 1984 election victory was the people's way of saying that they had "had it" with Carter-Mondale and all the wimpy, do-nothing policies of the liberals. Unfortunately, I think that the Reagan Administration has fallen far short of doing what has to be done. Reagan has talked loud and carried a tiny stick.

The beauty of the marketplace is that it bows to no president, it bows to no politician or group of politicians, it refuses to kneel before the Congress, the Treasury or the Fed. But when the market goes down, there isn't a politician in America who doesn't rack his brains in an effort to figure out what is going on.

Question: All very dramatic and all very interesting, Russell, but here you are reciting all these problems and your PTI is going to new highs? What do you make of that?

Answer: I have to be impressed with the market's strength in the face of the problems this country is facing. Of course, I also want the Averages to confirm the PTI, but that may take time. At any rate, it seems to me that the stock market is a lot more optimistic about the future than the economists and the newspapers and the trade journals.

Question: Do you see this market lapsing into a period of correction?
Answer: Well, we've corrected a bit since the July highs, and we could correct some more. But the strength of the Transports is very impressive, and the Transports would have to reverse and break down to really get a correction going. It's hard to see that happening now.

The truth is -- I'd love this market to correct. I think it would be healthy for Wall Street and I think a good decline would build technical strength. But the way the PTI and the Transportation Average are going, I put the odds for a full secondary correction at less than 50/50.

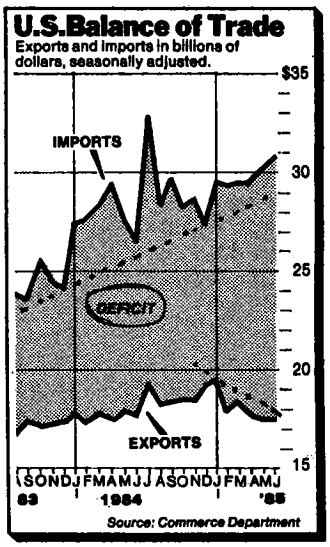
INVESTMENT POSITION: Daily new highs have dropped off precipitously on the NYSE, and everyone has duly noted this unhappy situation. Nevertheless, the PTI is at new highs and the bull remains in the box. Talk of "new leadership" abounds, and here the big cyclicals are the likeliest candidates. Strongest Dow stocks are Amer. Can, Chevron (!), DuPont, Exxon, Inco (!), Owens-Illinois, Westinghouse.

Stay with the bonds, do nothing in the precious metals, and be happy that you're not in the collapsing S.African mining shares. For high-income subscribers, muni bonds from your own state continue to make good sense and provide tax-free income that is very hard to beat. Smith Barney publishes a booklet covering comparative muni tax advantages in all 50 states, and the booklet is a must for serious investors. And, oh yes, taxes will be going up, despite what Reagan says.

CRITICAL CHARTS, CRITICAL FACTS: Let's face it, the guys at the Fed have opened the flood gates. Panicked at the idea of a recession in 1985 or '86, Volcker and the boys have gunned the money supply and they make no apologies for their actions. In fact, two weeks ago the Fed "revised" its monetary targets to allow for the great expansion in the money supply. Since February, M-1 has expanded at a compound

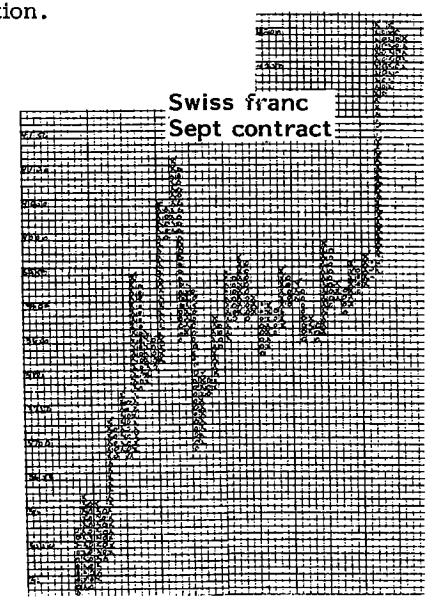
annual rate of 13%. Over the past month the rate has skyrocketed to 15%.

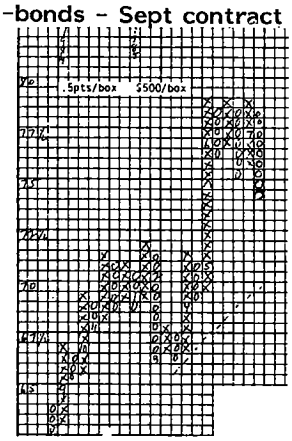
There are three momentous problems facing the US today: the huge compounding federal debt, the abysmal trade deficits and the high-priced dollar. The first two are worsening and the third is getting a bit better. The accompanying chart illustrates the trade-deficit problem, a problem that is to some extent a function of the dollar and to some extent a function of intense overseas competition.



Congressional spending is still out-of-control and is fast turning the US into the world's biggest "banana republic". My own feeling is that only a real crisis will bring Congress back to sanity.

Next, let's examine the chart of the Swiss franc (Sept contract). What we see here is an obvious bull market with the franc moving up from the 35¢ area to the 43¢ area. On any reading of this chart, the primary trend has turned against the dollar. The franc is over-bought now, and a correction would not be unexpected. The declining dollar will tend to boost US import prices and theoretically set off at least a mild spate of price inflation. With the weaker dollar and the exploding US money supply, most precious metal fans are now absolutely convinced that inflation will return. Their argument looks better now than at any time over the past few years. A price of 334.50 on gold, in my opinion, would confirm the inflationists' arguments. But -- it ain't happened yet!



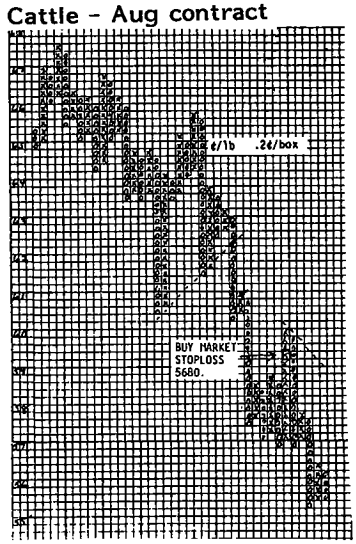


The buyers, the commodity traders, the international speculators, they are all now watching for signs of re-awakening inflation. If inflation does re-ignite, the ramifications are many. The specter of rising deficits and rising inflation will frighten the bond market (it is already doing that) and falling bonds mean higher long-term rates. Rising rates mean rising carrying costs and pressure on housing. I could go on and on, but at this point I feel it would be instructive simply to review the chart action of some key commodities.

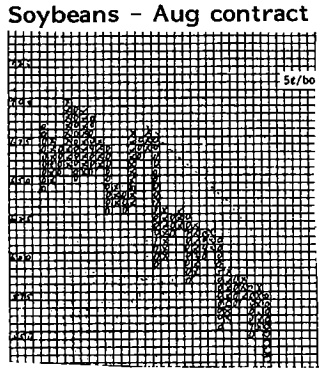
Remember, talk is talk, but reality is price action. Price action is set by hard-core decisions of men and women who put their cash on the line. I've learned from long experience that what a man says may be interesting, but where he puts his money is the crux of it. That's why the markets are such a fascinating study. They show us where people are slapping down their assets -- their hard-earned cash.

I've been talking about that 75 level on the Sept. T-bond contract. Well since the last Letter, the 75 level was broken, and in a strict technical sense (note the P&F chart) the bonds are now in a bearish mode. Interestingly (and perhaps significantly) the T-bills, the T-notes and the Muni Bond Index did not crack their June lows (comparable to the 75 level on the bonds), and this non-confirmation could be a hopeful sign. Then in the face of the heaviest Treasury re-financing in history (last week) the bonds rallied.

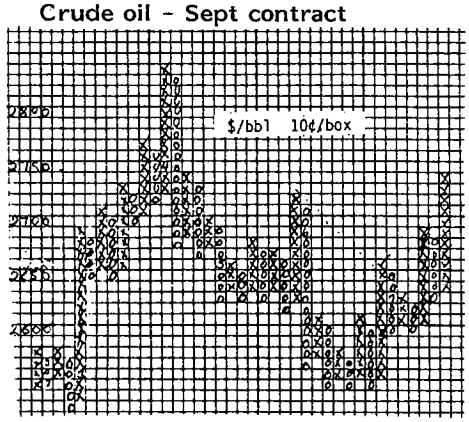
Cattle - Aug contract



Soybeans - Aug contract



Crude oil - Sept contract



The cattle market has been a disaster as this chart shows. Hogs have pretty much mirrored cattle. As you can see, since February, the cattle have dropped almost 17%, and there is no guarantee of a bottom yet. The same is true for the grain markets as the chart of soybeans indicates. I remember back in 1983 they were talking about "beans in the teens". Well, here are the soybeans in the 5.50 a bushel area, another disaster. Corn looks better than the beans, and we can only hope (for the sake of our farmers) the grains are bottoming here.

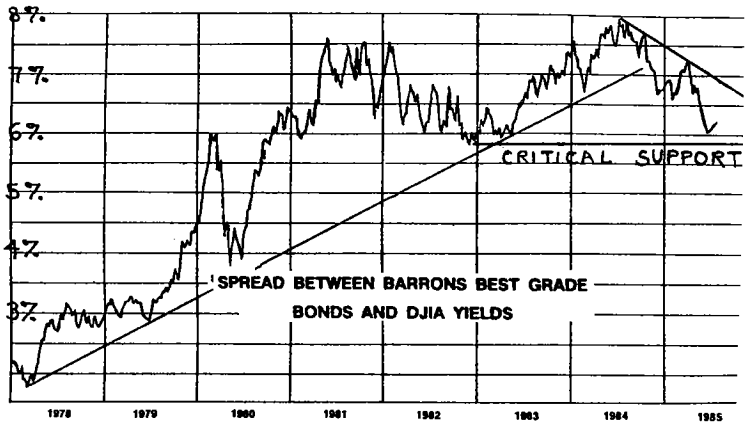
One of the fascinating mysteries here is crude oil. Despite months of dire predictions about OPEC, crude oil bottomed out at 25.50 (Sept contract), formed a powerful base and has given a series of bull signals, the latest occurring when crude climbed above 27.20

on the September contract. On the very big picture, oil is rallying within a bearish (declining) channel. But the intermediate-term trend for oil (believe it or not) is UP.

VALUES, RETURNS: This little statistical run-down should be of interest to all subscribers, but the first two entries are what I want to talk about. The total return (interest plus appreciation) on bonds over the last year (June 1, 1984 to June 1, 1985) was 42.9%. The total return on stocks was 28.7%. So it's the old Wall Street demand, "Don't tell me what to buy, tell me WHEN to buy it!"

OVER 1 YEAR

Bonds	42.9
Stocks	28.7
Old Masters	13.6
U.S. coins	11.5
Treasury bills	9.5
Chinese ceramics	5.9
(Consumer Price Index)	3.7
Housing	2.5
Diamonds	0.0
Oil	—4.5
Stamps	—9.6
U.S. farmland	—10.0
Foreign exchange	—11.3
Gold	—20.3
Silver	—34.3



Now turn to the long-term chart of the spread between top-grade bond yields and top-grade stock yields (top-grade stock yields as represented by the yields on the D-J Industrials). Note that this yield spread increased in favor of bonds between 1978 and 1984. By mid-1984, the bonds showed an extraordinary advantage of almost 8% in yield. (Chart courtesy of Smith Barney.)

Note that the yield spread topped in 1981 at the 7.5% level, sank to the rising trendline, then rose to 8% in 1984. In late-1984, a 7-year rising trendline in the yield spread was reversed. A declining trendline in the yield spread was then drawn on the chart.

What are the implications of this crucial chart picture? If the new declining yield spread continues, we will know that the advantage of bonds over stocks is diminishing. And this is exactly what Smith Barney believes is going to happen. Smith Barney believes that the inflation picture is now healthful and therefore a plus in the bond picture.

What do I think? I'm much more skeptical about the inflation and the bond picture than Smith Barney. I note the federal budget disaster, I note the decline in the D-J Utility Average (often a harbinger of higher interest rates) and I note the technically tenuous condition of the bond market. Therefore, I take a wait-and-see attitude. My guess is 50/50 the bond-stock yield spread is going to turn up and break the latest declining trendline. If that happens, bonds will be providing bargain yields again, and stocks may be under pressure (from high bond yields). The breaking point for the latest bond-stock yield trendline is 6.75%. I'll watch it and report immediately if we hit that yield spread.

But what, you may ask, will it mean if the bond-stock yield spread continues down? Such action would greatly enhance the attractiveness of stocks. And that in turn would be a tremendous stimulant to the current bull market on Wall Street. Nothing, I believe, would be more conducive to a stock boom than a continuation of the decline in the bond-stock yield spread, a decline that began in mid-1984 at a peak yield spread of 8% in favor of bonds.

LEARNING: Every successful investor I have ever known has followed a definite plan or system. And most of them have stayed with his or her system. I suppose this whole concept comes under the heading of persistence.

It may take you five or 10 years or more to develop a method or system that you have faith in. But you can't push nature and you can't force a conclusion. It all takes time.

One of the things you can do in this regard, however, is learn. Before I started Dow Theory Letters I spent two years doing NOTHING but reading Robert Rhea's market reports, written between 1932 and 1939. I read those reports until they crumbled in my hands. I read them until I really felt I was crawling into Rhea's mind. And in those two years, I learned the Dow Theory. But every few months or so I still go back and read Rhea's letters. And I still get a lot out of them.

Subscribers often ask me what they can do to further their understanding of the markets. My answer is -- read and study. "Yeah," they reply, "but read what?" In response I'm going to provide a short list of reading material that I think is very worthwhile.

As to periodicals, I recommend The Wall Street Journal (daily), Barron's (weekly) and Forbes (monthly). I also like Business Week (weekly) and Fortune (bi-weekly). There is an interesting magazine entitled Technical Analysis of Stocks and Commodities and you'll have to write for a sample of this at PO Box 46518, Seattle, WA 98146.

As to books, there are so many that the mind boggles. But Juncture Recognition (Box 1209, Pompano Beach, FL 33061) is well worth having. Another is Market Logic (3471 N. Federal Highway, Ft. Lauderdale, FL 33306). Then there is the classic, Technical Analysis of Stock Trends, by Edward and Magee, a book which is available at most major book stores.

Two volumes which I highly recommend. First is Dow-Jones Irwin Guide to Interest by Lawrence Rosen. People think I'm kidding when I recommend this book. I couldn't be more serious. I recommend that every serious investor become thoroughly familiar with what happens to money when you compound it. This book tells you.

I also recommend my chart book of the D-J Averages. This book traces the three D-J Averages plus the bonds and volume on a daily basis back to 1885. If you want this loose-leaf three-ring binder edition, I will send you excellent Xerox copies at $120 (make checks out to Richard Russell). I know no better way of studying the market than by knowing what happened in the past. This book tells you what, how and when.

NOTES & QUOTES: From our "Watch it" Dept: The Farm Credit System (Production Credit, Assoc., Federal Banks, Banks for Cooperatives) holds more than a third of the entire $212 billion in farm debt. The system is now squeezed, due to calls on its credit. The system has been forced to tighten up, raise certain interest rates and call certain loans. The main trouble has come from the Omaha area where 11 Production Credit Assoc. have closed down. ... Another "watch it": During the next year the FDIC expects to have 1,000 banks on its "trouble" list. Finally, this glad news from the savings and loan industry. All of which gives you some idea of why the Fed has opted to open the flood gates and allow the money supply to run wild.

> WASHINGTON (AP) — Almost 14% of the nation's federally insured thrift institutions were technically insolvent in 1984, posing a potential risk of $15.8 billion to the federal insurance fund, according to a staff study by economists at the Federal Home Loan Bank Board.
>
> The new report, disclosed during a Senate Banking Committee hearing yesterday, dramatically underscored the problems facing the nation's savings and loan industry.
>
> The $15.8 billion potential drain on the federal insurance fund, which protects deposits up to $100,000, dwarfs current assets in the fund — which totaled $5.6 billion at the end of 1984.

* *

Speaking of government, I thought this bit of federal madness was interesting. You know what the biggest lack in government is -- common sense!

The urge to quantify has always been strong in Washington, which may account for informal circulation in the Government of the following unexplained list:
Lord's Prayer: 56 words.
23d Psalm: 118 words.
Gettysburg Address: 226 words.
Ten Commandments: 297 words.
United States Department of Agriculture order on the price of cabbage: 15,629 words.

* *

San Diego housing may be among the most expensive in the nation, but once you buy your home here, the living is relatively easy. Recreation tends to be cheap, there are 320 days of sun each year, and there is coastline and beach everywhere. To the east are the Laguna Mountains and the Anza-Borrego desert state park (a rock-hound and desert flower fancier's heaven). In a 1984 study of 23 major cities, San Diego came in next-to-the-lowest in food prices at -17.4% of the average. Tampa as the lowest at -18.5%, Chicago was third at -10.6%, then Philadelphia at -6.6%. Most expensive in order were Anchorage at plus 34.9%, Washington, DC, at plus 23%, NYC at plus 14.6%, Denver at plus 12.1% and Dallas at plus 5.3%.

San Diego's population is still booming, so I've promised friends not to mention it in a good light any more. Want to worry? Mexico just devalued the peso another 32%, and people south of the border (just 25 miles south of San Diego) are starting to talk about "getting rid of the government". So somewhere ahead San Diegans could be living just a big stone's throw from major trouble.

* *

They've got old EF Hutton against the wall on check kiting charges. And my guess is that individual indictments will eventually come out of all the investigations. But heck, the banks have been doing it to you and me for years. A recent survey of 699 banks shows that 70% of these savings institutions held local checks for three business days or more, while 75% of the banks held out-of-state checks for more than a week. That kind of nonsense has always bugged me, but today, in this age of fast computers and express mail, there's no excuse for it. I've had an account with Hutton for many years, but what the banks do to me costs me money. What Hutton did never hurt me, it only hurt the banks. Many subscribers have asked me if Hutton is still safe. I think Hutton's as safe as it ever was. And from now on, you can bet they'll be the cleanest brokerage house in town.

* *

I'll be up in Vancouver at the ISI Seminar this weekend, and from what I hear in advance the seminar should be a great success. ... Subscribers should have received a brochure for the November NCMR Seminar in New Orleans in the last mailing. Jim Blanchard has put together a group of speakers the likes of which, and the quality of which, I have never seen before at NCMR or anywhere else. The New Orleans conference is one of the big get-togethers of the investment world, and it's as much fun as it is educational. Hope to see many of my subscribers there.

* *

Survival notes: As I've said so many times, there's no use making money if you can't keep yourself alive to enjoy it. Thus, I occasionally include survival notes in these Letters. And a big survival problem for women these days is rape. Police experts now tell women to FIGHT with anything at their command (shoes, pins, fists, fingers in the eye) and to scream rather than give in passively to a rapist. The rapist loves to hear a woman beg, but he may not appreciate a woman who fights and screams. Last week I read about one of our spirited California women who bit off a man's finger while she was struggling with a rapist. I thought the story would be of interest to my many lady readers: here's an excerpt (the man was later arrested at a hospital were he appeared for treatment):

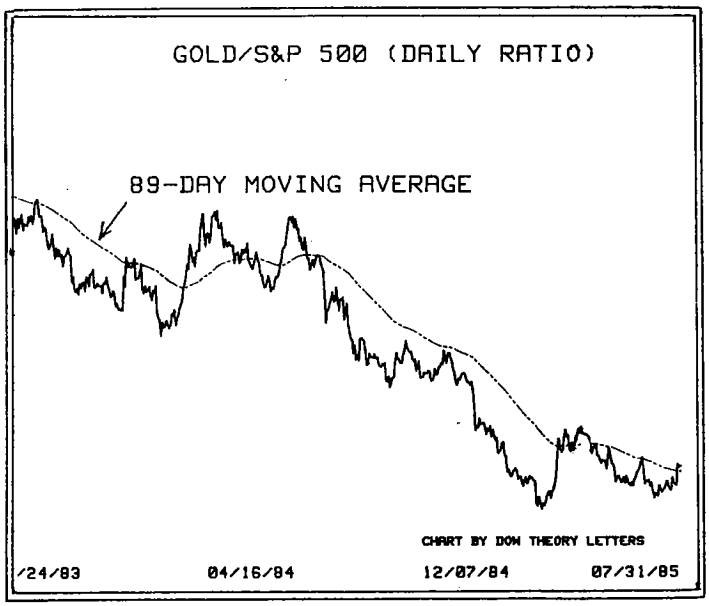
> In Thursday's incident, Wilson allegedly broke into the apartment of a 34-year-old television producer at 4:15 a.m. Barthelmess said that after the suspect removed the screen and climbed through a living room window, he crept into the small, cramped bedroom where the woman was sleeping.
>
> The woman later described the events to reporters, agreed to pose for photographs but asked that her name not be used.
>
> When she saw an unknown man standing over her wearing gloves and a covering over his head, she said, she became "angry, not scared."
>
> "I was ready to fight," she said. "I've taken some self-defense, and I've got a yellow belt in karate, so I was getting ready. I guess he didn't appreciate the screaming because he pushed me back down on the bed and put his hand over my mouth so I couldn't scream."
>
> She said one of the man's fingers slipped into her mouth, and she instinctively bit down on it. She said the man ripped his bleeding hand from her mouth and ran out of the room.

* *

I just don't know if our current political system is working. The Founding Fathers envisioned citizen-statesmen running the nation, men who would come to Washington, do their patriotic jobs, then go back to work as civilians. This business of four- and five-term Congressmen, men who will do anything to get elected and re-elected, just isn't working. We've got to go to a limit of say eight years in office for Congress. Otherwise, we're going to go into a budget crisis that'll curl our hair. These professional long-term politicians just AREN'T GETTING THE JOB DONE.

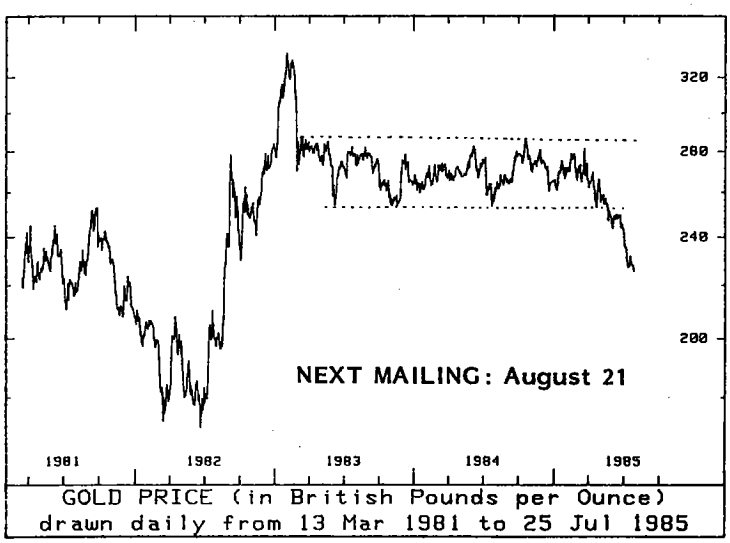
GOLD, SILVER: On July 29, the CRB Commodity Futures Index broke below 220 for the first time since 1978. That's a very deflationary development. Frankly, the commodity charts are in tatters, as you must know by now.

Next, there's trouble in S. Africa, lots of it. And in the few weeks since S. Africa declared a state of emergency, the S. African gold shares have lost a fifth of their value. Part of this is due to the big slide in the rand, so between the rand and the riots, gold share prices are way down (ASA has been hit hard, dropping under 45).



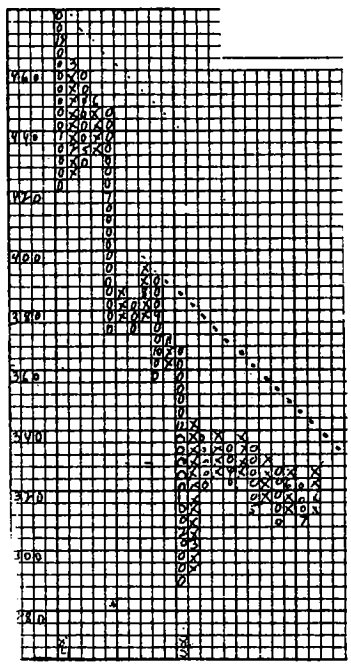
My friend (and computer expert) John Carder just sent me this shocking chart of gold in terms of British pounds (gold looks the same in terms of all foreign currencies). Here we see the frightful break in the pound price of gold over the last few months, a break following two solid years of sideways fluctuations. So the question has to be asked, "Why don't foreigners want gold?" The answer, I guess, is that (1) they are not thinking in terms of inflation, and (2) they want interest on their money, and gold pays no interest.

Also on this page is my chart of the gold-common stock ratio. I've written many times that one requirement for a bullish gold market is gold acting better than common stocks on a trend basis. Thus, the ratio of gold to the S&P 500 provides the picture. In general, this ratio has been going down (in favor of common stocks) ever since 1980. Lately (see chart), the ratio has tried to look better, but I'd have to term the ratio neutral/bearish but certainly not bullish. Therefore, the background mode for gold is still nothing to get excited about.

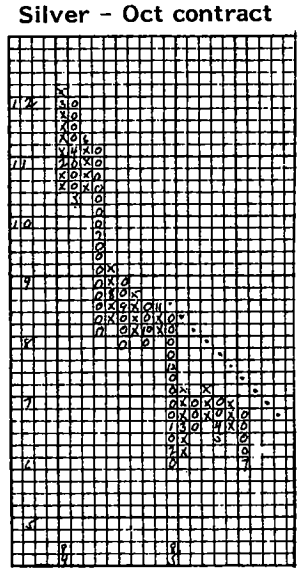


Finally, let's turn to the point & figure charts of gold and silver (charts courtesy of Chartcraft, Larchmont, NY). Gold hit its low of 284.25 (London fix) in February 1985. So far that low has held, despite broad commodity weakness. The gold chart shows a potential sell signal if gold hits 308. A first buy signal comes in at 332, and a much more important bull signal at 348. For silver, we have a sell signal at 5.80, and a buy signal at 7.40. Note that both metals are fluctuating below a bearish trendline. A spot price of 348 would break gold out above its declining trendline, an event which would be a big technical accomplishment.

Gold - Aug contract



Silver - Oct contract



Conclusion: The gold and silver picture is not encouraging. Some of the North American gold mining shares have risen in reaction to the possibility that the S. African gold mines will be crippled. But the fact is that the riots in S. Africa and the problems in the international banking picture would have sent gold through the roof if gold was in a primary bull market. To me, gold has been a difficult performer and a costly one for gold bulls. I'm continuing to "stand aside" (as the commodity boys would put it). Yeah, I'm tired of saying that over and over in Letter after Letter, but you don't pay me for hopes and wishes, you pay me for my judgment. And I find the gold action discouraging.

LATE NOTES: The Congressional budget "agreement" was an absolute disgrace. Commented Senator Dole, "We really haven't cut Federal spending. ... And we really haven't reduced the deficit that much." In response to Congress's cowardly inaction, the bond market swooned and the Sept. T-bond contract sank decisively below 75. But the stock market gives ground grudgingly, and volume dries up on any selling. You have to be impressed with the stock action.